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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

COMPETITIVE PRODUCT LIST ADDING ROUND-TRIP MAILER	))	Docket No. MC2013-57
COMPETITIVE PRODUCT LIST ADDING ROUND-TRIP MAILER (MC2013-57)	))	Docket No. CP2013-75

GAMEFLY, INC., RESPONSE TO UNITED STATES POSTAL SERVICE UPDATE TO RESPONSE TO COMMENTS (January 29, 2014)

GameFly, Inc. ("GameFly") hereby responds to the "Update to Response to Comments" filed by the Postal Service on January 22, 2014. In its pleading, the USPS asserts that a November 2013 statement of the Federal Trade Commission ("FTC") announcing the decision of the agency not to oppose the proposed merger of Office Depot, Inc., with OfficeMax, Inc., shows that the FTC has repudiated competition findings it made in *FTC v. Staples*, 970 F. Supp. 1066 (D.D.C. 1997), a case previously cited by GameFly, and "calls into question GameFly's arguments regarding market definition included in its [September 13, 2013] Supplemental Comments" in this docket. *Id*. The Postal Service has misread the recent FTC pronouncement, which in fact provides further support for GameFly's position.

GameFly cited *FTC v. Staples*, along with several other cases, for the principle that, when product markets are split into sub-markets by differences in product characteristics or consumer preferences, a "core group of particularly dedicated, ‘distinct customers,’ paying ‘distinct prices,’” may constitute a distinct market that must be analyzed separately. *FTC v. Staples, Inc.*, 970 F.Supp. 1066, 1078-79 (D.D.C. 1997); *accord*, *FTC v. Whole Foods*, 548 F.3d 1028, 1039 (D.C. Cir. 2008); *Meredith Corp. v. SESAC, LLC*, 2011 WL 856266 (S.D.N.Y. 2011); *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962); GameFly Supplemental Comments (September 12, 2013) at 28-31 (discussing cases).

FTC v. Staples, one of the cases cited by GameFly, arose from an FTC suit to enjoin the proposed merger of two major chains of office products superstores, Staples and Office Depot. The defendants argued that the merged entity would have only a small share of the overall market for office products. The District Court, enjoining the merger, rejected this product market definition in favor of a narrower market limited to the office products superstores. The 1997 decision, while acknowledging that a high degree of functional interchangeability existed between the office supplies sold by the office super stores like Staples and Office Depot vs. other retailers of office supplies, including clubs, mass merchants such as Wal-Mart, and computer stores, nonetheless found that the “unique combination of size, selection, depth and breadth of inventory offered by the superstores distinguishes them from other retailers.” 970 F.Supp. at 1079.

These precedents are controlling here. The consumers who prefer to play the wide selection of console games offered on rental DVDs by GameFly do not regard the more limited selection of games available via other distribution channels as an adequate substitute. Accordingly, the two groups of consumers represent different markets, and cannot be lumped together in analyzing the competition that GameFly faces—let alone the competition that the USPS faces for the delivery of GameFly's DVDs. GameFly Supplemental Comments (September 12, 2013) at 37-51; GameFly comments (August 15, 2013) at 23-29. The same is true of entertainment videos. The core group of consumers who want the wide selection of videos offered by Netflix through its DVD-by-mail service, and the specialized selection of videos offered by smaller DVD-by-mail rental companies, do not regard the much more limited selection of entertainment content available by Internet streaming or rental from self-service kiosks to be an adequate substitute. GameFly Supplemental Comments (September 12, 2013) at 34-37; GameFly comments (August 15, 2013) at 14-23.

The FTC's acquiescence 16 years later in the merger of Office Depot, Inc., and Office Max, Inc., reflected merely a change in market conditions, not a repudiation of the standards for competition analysis set forth in the above decisions. The FTC found, after a seven-month investigation, that major changes had occurred in the office supply market during the 16 years between the two cases. In particular, the FTC found that the proliferation and expansion of office supply offerings at brick-and-mortar mass merchants such as Wal-Mart and Target and club stores like Costco and Sam's Club, and the "explosive growth of online commerce," including retailers such as Amazon, now present retail consumers with a broad range of alternative sources of "consumable office supplies" that consumers consider to be good substitutes for the range of products available from office supply superstores. FTC File No. 131-0104, *FTC Statement Concerning the Proposed Merger of Office Depot, Inc. and OfficeMax, Inc.* (November 1, 2013) at 1-2 (attached *infra*). Likewise, the FTC found that business and government purchasers of office supplies have a wide range of alternative suppliers, including Staples and "dozens, if not hundreds," of contract office suppliers. *Id*. at 2-3.

The FTC concluded by emphasizing that its approval of the merger should not be construed as a change in the agency's underlying competition standards or, as the Postal Service erroneously tries to do in its filing, generalized to other transactions or markets:

> Analyzing the likely competitive effects of a proposed transaction is always a fact-specific exercise that must take into account the evolving nature of markets. Our decision highlights that yesterday's market dynamics may be very different from the market dynamics of today. In this case, significant developments in the market for consumable office supplies have led us to approve a merger when we had blocked a similar merger sixteen years ago. ***In so finding, we emphasize that our decision, including our view of the competitive interaction between brick-and-mortar retailers and Internet sellers, is limited to the facts before us in this particular matter.***

Id. at 3 (emphasis added).

A comparison of the level of analysis performed by the FTC in the Office Depot/OfficeMax merger case, and that presented in the Postal Service's request to exempt DVD mail from maximum rate regulation, underscores the deficiencies in the Postal Service's case. The FTC's 2013 analysis was based on a seven-month investigation of the substitutability of the "consumable office supplies" offered by the two merger applicants and competing sellers, including an "extensive" series of econometric analyses, comparisons of prices in markets with varying numbers of office supply superstores, and "events studies" analyzing the impact of office supply superstore closings on the prices charged by remaining office supply superstores in local areas. *Id*. at 2. The Postal Service has offered no comparable analysis or evidence in the present case. To the contrary, the evidence offered by GameFly, Netflix, and smaller DVD rental companies overwhelmingly shows that the core group of consumers who rent

DVDs by mail from these companies still regard the more limited content available from alternative distribution channels as poor substitutes.

The present case is distinguishable from the 2013 FTC case in a second and equally crucial respect: the ultimate question before the Commission here is not whether GameFly or Netflix face effective competition, but whether the Postal Service does. That is, is there sufficient competition to make a small but significant non-transitory increase in price (i.e., the amount of postage charged for a DVD round-trip mailer) unprofitable for the Postal Service? The Postal Service has provided absolutely no evidence that this is the case; and its subclass-level demand equations strongly suggest that it is not.

Because the *Postal Service* lacks effective competition for the delivery of round-trip DVD mailers, any competition that DVD rental companies face would simply force them to absorb the rate increases that the Postal Service would impose if its maximum prices were deregulated. GameFly Supplemental Comments, *supra*, at 8-17 (discussing elasticity data and other evidence). This is a legally fatal defect in the USPS case. *Id*. at 5-6 (discussing *Coal Exporters Ass'n of United States v. United States*, 745 F.2d 76, 84-85, 93, 95, 99 (D.C. Cir. 1984), and *General Chemical Corp. v. United States*, 817 F.2d 844, 854 (D.C. Cir. 1987)).

The Postal Service, once again, offers no serious response to these points. That consumers frequently "utilize[e] multiple methods of accessing digitized entertainment content" (USPS Update at 6) supports GameFly's position, not the Postal Service's. As GameFly noted in its August 15 comments (at 15), approximately two-thirds of Netflix's customers who subscribe to the company's DVD rental segment also subscribe to the company's streaming service *even though the subscriber must pay separately for each, with no combination discount*. Netflix letter to shareholders (October 23, 2012) at 9 ("Over two-thirds of these DVD members also subscribe to our streaming service."). If subscribers to DVD-by mail considered video streaming to be a good substitute, one would not expect so many subscribers to pay twice to receive both.

The notion that the Postal Service faces effective competition for DVD mail because GameFly and Netflix "utilize national pricing policies" (USPS Update at 7) is an obvious non sequitur. The main defect of the Internet and Redbox kiosks as competitive substitutes for DVD rental companies is not their limited geographic reach (an issue in *FTC v. Staples* and the reason that the FTC reanalyzed the issue in the 2013 Office Depot/OfficeMax case), but the limited selection of content available from alternative channels for distribution of video game and entertainment content, and (with respect to downloadable games) the limited performance quality.

It is true that Internet distribution of games and entertainment content does suffer from a further, geographic limitation: this distribution channel requires high speed broadband service, which the FCC has found is still unavailable in many rural areas. GameFly Comments (August 15, 2013) at 14-29. *Accord*, FCC Eighth Broadband Progress Report, GN Docket No. 11-121 (August 21, 2012) (available at http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-12-90A1.pdf) at 3 ¶ 1:

> [A]pproximately 19 million Americans live in areas still unserved by terrestrial-fixed broadband. For these and other reasons, we must conclude that broadband is not yet being deployed "to all Americans" in a reasonable and timely fashion.

See also *id*. at 165-166 (maps). That DVD-by-mail rental companies, including GameFly and Netflix, offer uniform prices nationwide does not disprove this point: even in geographic areas where high speed broadband service is available, the modest selection of game and entertainment content that is available for distribution over the Internet remains an independent limitation of this channel.

The Postal Service is correct, of course, that the existence of *non-uniform* prices can, in many contexts, provide evidence that effective competition is absent. As GameFly has previously noted, it is "well established that the ability of a firm to price discriminate is an indicator of significant monopoly power." *Coal Exporters Ass'n*, *supra*, 745 F.2d at 91 (quoting antitrust treatises); F.M. Scherer, *Industrial Market Structure and Economic Performance* 459 (3d ed. 1990). The only party in this case that is attempting to price discriminate, however, is the Postal Service, which has litigated tooth and nail for almost five years for the right to continue engaging in price or service discrimination against GameFly.

Respectfully submitted,

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ATTACHMENT

Statement of the Federal Trade Commission

Concerning the Proposed Merger of Office Depot,

Inc. and OfficeMax, Inc*.*

FTC File No. 131-0104

November 1, 2013

Statement of the Federal Trade Commission
Concerning the Proposed Merger of Office Depot, Inc. and OfficeMax, Inc.
FTC File No. 131-0104
November 1, 2013

The Commission has unanimously decided to close its seven-month investigation of Office Depot, Inc.'s proposed merger with OfficeMax, Inc., a transaction that aims to combine the country's second and third largest chains of office supply superstores (OSS).[1] Although sixteen years ago the Commission blocked a proposed merger between Staples, Inc. and Office Depot, the nation's two largest OSS, our current investigation has shown that the market for the sale of consumable office supplies has changed significantly in the intervening years. For the reasons discussed below, we conclude that Office Depot and OfficeMax should be permitted to move forward with their proposed transaction. In reaching this conclusion, we assessed the proposed merger's competitive effects in two distinct lines of commerce: the sale of office supplies to retail and contract customers. We discuss each in turn.

I. Retail Channel

In the 1997 *Staples* case,[2] the Commission successfully argued that the relevant product market was the sale of consumable office supplies through OSS and that the proposed merger of two of the three OSS would lead to competitive harm.[3] In finding an OSS-only market, the *Staples* court relied principally on qualitative and empirical evidence that OSS prices were set according to the number of competing OSS in a local area. Company documents revealed the merging parties' intense competitive focus on other OSS and general lack of concern with non-OSS rivals. The evidence also showed that the defendants grouped their stores into price zones specifically based on the number of nearby OSS, resulting in higher prices in local markets with fewer OSS, even if non-OSS competitors were present.

The current competitive dynamics are very different. The Commission's investigation shows that today's market for the sale of consumable office supplies is broader, due mainly to two significant developments. One is that customers now look beyond OSS for office supply products and rely more heavily on non-OSS brick-and-mortar retailers. Mass merchants like Wal-Mart and Target and club stores like Costco and Sam's Club have proliferated and expanded their product offerings and sales of office supplies. The result is that fewer consumers today shop OSS as a destination. Instead, consumers place a greater premium on convenience, preferring in many cases to purchase supplies at retailers that also offer other products that office supply customers purchase.

The other is the explosive growth of online commerce, which has had a major impact on this market. Online retailers stock a vast array of office supply products and can deliver them quickly anywhere in the country at nominal cost. Company documents show that OSS are

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[1] The Attorneys General of several states joined in the Commission's investigation.

[2] *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997).

[3] "Consumable office supplies" refers to non-durable products that consumers use up, discard, and purchase on a recurrent basis. Examples included pens, paper, file folders, Post-it notes, and ink and toner cartridges. *Id.* at 1080.

acutely aware of, and feel threatened by, the continued growth of online competitors, most notably Amazon. OSS have lost, and continue to lose, substantial in-store sales to online competitors. This increased competition from online retailers has caused OSS to respond with new pricing practices and other strategies. For example, because online prices are often lower than in-store prices, and because many customers comparison shop in-store prices against online prices, OSS are often pressured to match these lower online prices in their stores. And, in-store and online channel boundaries are blurring as OSS seek to create a seamless customer experience by offering in-store pickup for online orders and using in-store Internet kiosks to order products online.

The merging parties' pricing policies and practices reflect these changes in customer behavior and now specifically factor in non-OSS competition. Price zones and retail pricing are no longer dictated by the number of local OSS. In fact, a majority of products sold by the merging parties are priced nationally, and the products priced locally take into account competition from non-OSS retailers. OSS closely monitor, and respond competitively to, other non-OSS retailers. This competitive interaction includes price-checking, price matching, and advertising and promotion designed specifically to compete effectively with non-OSS retailers.

The econometric analysis reflects the new competitive dynamics in the industry and shows that the proposed merger is unlikely to result in anticompetitive price effects. Commission staff replicated the type of econometric work performed in *Staples* and conducted an extensive amount of additional econometric analysis, including comparisons of prices in markets with varying numbers of OSS and "events studies" analyzing the impact of OSS store closings on the prices charged by remaining OSS in local areas. All of the econometrics, none of which assumed or depended on any particular definition of a relevant product or geographic market, indicate that the merger is unlikely to lead to anticompetitive price increases.

Altogether, the overwhelming evidence supports the conclusion that OSS today face significant competition and demonstrates that the proposed merger is unlikely to substantially lessen competition in the retail sale of consumable office supplies.

II. Contracting Channel

The Commission also examined the potential for competitive harm in the sale of consumable office supplies to businesses and other customers on a contract basis, a channel not at issue in *Staples*. Many businesses and public entities purchase office supplies under a contract. Unlike retail purchasers, contract customers typically receive discounted pricing based on actual or anticipated purchase volume. These contracts allow customers to order office products at previously negotiated prices. Because there are dozens, if not hundreds, of office suppliers that compete effectively to serve small and medium-sized businesses, the investigation focused on contracts for large multi-regional or national customers, which typically have the most demanding purchasing requirements and, as a result, fewer potential suppliers capable of meeting their needs.

A substantial body of evidence indicates that the merger is unlikely to substantially lessen competition or harm large contract customers. First, large customers use a variety of tools to ensure that they receive competitive pricing such as ordering certain products (like ink and toner) directly from manufacturers and sourcing (or threatening to source) certain categories of office supply products from multiple firms. Second, the merging parties' documents show that they are rarely each other's closest competitor for most large customers and that non-OSS competitors take business from the parties in a substantial number of contracting opportunities. Third, the parties will continue to face strong competition for such customers from Staples and a host of non-OSS competitors, such as W.B. Mason Co., Inc. Non-OSS competitors are growing in number and strength and have demonstrated the ability to win large multi-regional and national customer contracts. In particular, regional office supply competitors have developed and utilized various strategies to compete successfully for large national accounts, including working with office supply wholesalers and joining cooperatives of independent office supply dealers to create a distribution network capable of meeting the needs of large multi-regional and national customers. Finally, potential competitors in adjacent product categories, such as janitorial and industrial products, have existing contractual relationships with large office supply customers and can leverage those relationships to enter the office supply distribution market.

In light of the foregoing, there was little concern from contract customers about the proposed merger, and even the largest customers believe the merger would be either pro-competitive or competitively neutral. We therefore find that the proposed merger is unlikely to result in competitive harm in the contract channel.[4]

III. Conclusion

Analyzing the likely competitive effects of a proposed transaction is always a fact-specific exercise that must take into account the evolving nature of markets. Our decision highlights that yesterday's market dynamics may be very different from the market dynamics of today. In this case, significant developments in the market for consumable office supplies have led us to approve a merger when we had blocked a similar merger sixteen years ago. In so finding, we emphasize that our decision, including our view of the competitive interaction between brick-and-mortar retailers and Internet sellers, is limited to the facts before us in this particular matter.

[4] We also assessed the potential for coordinated effects, but found that market conditions, including the number and diversity of competing firms, the complexity of contract terms, and the lack of transparency into the identity of bidders and terms of contracts and bids, would render post-merger coordination or market allocation difficult.